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May 27, 1997

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P O Box 25165 MS3101
Denver CO 80225-0165

RE: Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil - 62 Fed. Reg. 3741 (January 24, 1997)

Dear Mr. Guzy:

The Council of Petroleum Accountant's Societies (COPAS) appreciates the opportunity to comment on the MMS' proposed rulemaking governing oil valuation for federal leases. COPAS members have extensive experience with Royalty Management Program (RMP) rules and handle royalty valuation, allowances, adjustments, bills, audits, and other royalty matters on a regular basis. Therefore, we believe our comments will be beneficial in improving RMP processes for both the MMS and industry.

COPAS' comments will be divided into five parts; (1) General Comment, (2) Specific Comments, (3) Response to MMS' Specific Questions, (4) Form MMS-4415, and (5) Conclusion.

General Comment

MMS states in the General Description of the Proposed Rule section that "The proposed rulemaking would add more certainty to valuation of oil produced from federal lands and eliminate any direct reliance on posted prices." In the proposed rule, MMS has eliminated reliance on posted prices, however COPAS does not believe that MMS has added more certainty to the valuation of crude oil. COPAS believes MMS has proposed an extremely complex formula for the determination of royalty value which would have to be used by the vast majority of lessees. COPAS also believes that the formula MMS has proposed is flawed, so flawed that it is totally unusable.

As accountants, COPAS focused its review on the practical applications of the proposed rule. In reality, we found the proposed rule to be impractical and ineffective. This dramatic departure from lease terms and past practice will result in imposition of a costly and burdensome methodology that will be difficult to comply with, unworkable, and expensive to administer. Furthermore, it will require many smaller, independent companies to pay royalties on a value which is higher than they received for their production.

In the proposed rule, MMS has deviated from its long history of determining value at or near the lease. MMS is proposing to define market value as the NYMEX futures price for Domestic Sweet Intermediate Crude Oil at Cushing, Oklahoma, a point hundreds of miles from virtually all federal lands. Under this new concept of market value, MMS has decided to ignore a very competitive market for crude oil at or near the lease and has also decided that thousands of arm's-length contracts are no longer valid for royalty determination purposes. MMS' significant deviation from past practices is alarming.

Therefore, COPAS recommends the proposed rule be withdrawn.

Specific Comments

Section 206.101 Definitions - MMS states in the preamble that the definition of "Marketing Affiliate" has been deleted. Due to the numerous administrative and legal actions concerning the affiliate issue, COPAS believes that the removal of this definition is premature. We urge MMS to retain this definition pending a final resolution of these issues.

Gross Proceeds means ... "Gross proceeds include payments for services such as dehydration, measurement, and/or gathering which the lessee must perform at ...". COPAS recommends the word "must" be changed to a more neutral term. The word "must" implies there is never or will never be a situation where the cost of those services would be deductible. This is unrealistic and inflexible.

"Index pricing means using NYMEX futures prices or Alaska North Slope (ANS) crude oil spot prices for royalty valuation." COPAS believes that the reference to NYMEX and ANS spot prices should be changed to more generic language. As written, the definition allows no future flexibility.

Section 206.102(a)(3)(ii) - "If you cannot justify the value to MMS' satisfaction...". MMS needs to provide criteria or examples of what would constitute MMS' satisfaction. The way the paragraph is written currently, value determination is left to the judgement of the person who is making the decision and as such, is subject to arbitrary interpretation. Therefore, COPAS believes there must be some regulatory criteria upon which to base this determination.

Section 206.102(a)(6) - "Even if you have an arm's-length contract for the sale of your oil, you must value your oil under paragraph (c)(2) ... if you or your affiliate purchased crude oil from an unaffiliated third party ... in the two-year period preceding the production month." COPAS believes this requirement is far too broad. What MMS has done in this paragraph is to virtually eliminate all arm's-length contracts as a basis for royalty valuation. With a stroke of the pen, MMS has arbitrarily decided that market value of crude oil will be determined in a manner different from other products in the United States. COPAS does not agree with MMS' proposal. In fact, COPAS does not believe it could ever agree to a situation where a lessee would be required to use an alternative valuation method when it had an arm's-length contract. Arm's-length contracts have always been, and should continue to be, an acceptable method for royalty valuation .

206.102(c)(2)(i) and (ii) - In these paragraphs, MMS states how value will be determined if a lessee can not value under the gross proceeds method. COPAS does not agree that value should be determined in the manner MMS proposes. MMS is ignoring the highly competitive, very active lease market that exists today in favor of a market hundreds of miles from the lease. COPAS does not believe this is proper or in accordance with lease terms.

To illustrate our concern with MMS' proposal, let us imagine that you own an apple orchard but you have to lease the land on which the orchard was located. Part of your lease agreement with the land owner states that the lessor is to be paid a percentage of the apples. You grow the apples and sell them to Company A which, besides purchasing your apples, also buys apples from other orchards in the area. Company A takes all the apples fifty miles down the road to the local community where it sells the apples to the local grocery store. When you go to pay the lessor his share, he says that either because you purchased an apple from another grower or because he does not believe that the value of apples at the orchard is really the market value of apples, his share is to be valued at what Company A received from the grocery store. That is the equivalent of what MMS is proposing. MMS is ignoring the market in the field in favor of a market miles from the lease and defining the price received there as market value. What MMS proposes is inherently unfair to the lessee.

Section 206.102(e) - This paragraph states, in part, "(1) You must place oil in marketable condition and market the oil for the mutual benefit of the lessee and the lessor at no cost to the Federal Government unless otherwise provided in the lease agreement or this section." COPAS agrees that lessees may have to place the oil in marketable condition, but strongly disagrees with the remainder of the sentence. COPAS would agree that lessees must market for the mutual benefit of the lessee and the lessor at the lease, but the way this paragraph is written, it could be interpreted that lessees must market downstream of the lease. Also, this language changes the lessee's obligation from a duty to place production in marketable condition to a duty to market. COPAS does not believe there is any requirement in the lease agreement that requires lessees to market downstream of the lease. Also, the lessee is not obligated to market at NO cost to the lessor. MMS is taking the lessee's obligation to place oil in marketable condition and trying to expand that obligation to require lessees to market

at no cost. MMS is contradictory in saying lessees must market to the mutual benefit of the lessee and lessor at no cost to the lessor. Where is the mutual benefit when one party must bear all the costs? COPAS recommends that this language be stricken and the current language be retained.

Section 206.102(e)(2) states "If you are entitled to a credit, MMS will provide instructions for taking that credit." COPAS does not understand the meaning of this sentence. The Federal Oil and Gas Royalty Simplification and Fairness Act already allows the lessee or its designee to recoup overpaid royalties. This should be clarified if MMS decides not to withdraw the rule.

Section 206.157(f) states "May I ask MMS to determine value?" COPAS believes that this sentence should read "May I propose an alternative valuation methodology?"

Section 206.102(g) states, in part, "... closing of the audit period does not foreclose MMS from correcting the error and collecting any royalties due." Pursuant to provisions of the Federal Oil and Gas Royalty Simplification and Fairness Act, closing of the audit period does foreclose any further action by MMS.

Section 206.103 - MMS states in the preamble that this section is not being revised. Paragraph (a)(1) of this section states "Royalties shall be computed on the quantity and quality of oil as measured at the point of settlement approved by BLM or MMS for onshore and offshore leases, respectively." MMS has defined a number of location and quality differentials in the proposed rule, but they all stop at an aggregation point. There is nothing in the proposed rule that allows the lessee a gravity adjustment between the point of settlement and the aggregation point.

Section 206.104(c) - MMS needs to clarify if the 50 percent limitation is determined at an aggregation point before or after the differential.

Section 206.105(c)(i) - COPAS does not believe the location and quality differential MMS is proposing (i.e., NYMEX value adjustment using the published spot market price at a market center) is proper. Spot market prices represent a price that a refiner was willing to pay to fill a small portion of its refinery capacity. Certainly, it is not a price to represent a location difference between Cushing, Oklahoma and the respective market center as defined by MMS.

Section 206.105(c)(ii) - This location/quality differential can only be used if an exchange agreement specifies from which leases the oil is deemed to come. Beyond that, it is impossible to trace a specific barrel of crude oil once it is commingled with crude from other leases. Therefore, a lessee does not always know to which lease an expressed differential applies. Furthermore, a differential in an exchange agreement is a trading difference and is not

intended to define costs between an aggregation point and the market center. It is possible for a lessee to have an exchange agreement between an aggregation point and a market center in which there was no differential. COPAS does not believe that the use of differentials stated in exchange agreements is proper.

Section 206.105(c)(iii) - COPAS is opposed to this section for basically the same reasons as stated above, but also has additional concerns related to this section. MMS proposes to gather data for the past year and to publish differentials for the current year based upon the data gathered. This method fails to recognize changing market conditions. It assumes the market conditions that existed in the past are the same market conditions that exist currently. COPAS simply does not believe this assumption is accurate. COPAS also has significant concerns as to how MMS is going to interpret the data gathered and how industry can determine whether MMS' published results reflect true costs. COPAS also has concerns regarding incomplete data as no information will be collected from non-federal lessees. COPAS simply does not believe what MMS has proposed is a viable solution.

Section 206.105(c)(iv) - COPAS does not believe the majority of lessees knows or has access to the actual cost of transportation as defined by MMS from the aggregation point to the lease, especially if they are selling oil at the sales meter. If a lessee is moving the oil to the aggregation point, it may be an extremely burdensome process to determine the actual cost because it has not previously been necessary to track costs in this manner. What MMS has proposed is simply not a viable method for a majority of lessees.

Section 206.105(c)(4)(iii) - The penalty MMS proposes is extremely harsh and is akin to the old allowance payback penalty. Properties are constantly being acquired, new wells may be drilled on leases which are currently non-producing, or there may be other situations where the lessee simply does not know he needs MMS to calculate a differential. Also, the Federal Oil and Gas Royalty Simplification and Fairness Act specifies refunding overpayments as an obligation of the Secretary; therefore, there may be a legal question regarding MMS' intent not to refund overpayments.

MMS states in the preamble that Section 206.105(b)(5) is being deleted. COPAS believes that deleting this paragraph is a premature and unnecessary action on MMS' part.

Response to MMS Specific Questions

MMS asks a number of specific questions in the proposed rule. COPAS' response to several of these questions are as follows:

1. MMS requested comments on Form MMS-4415.

   See COPAS comments on this form elsewhere in this letter.

2. MMS asked for comments on publishing an Interim Final Rule.

   COPAS strongly objects to the issuance of an Interim Final Rule, rather than a Final Rule, due to the significant compliance costs involved in two implementation processes. The flexibility the MMS assumes would result from an Interim Final Rule would come at a high cost to both Industry and the MMS. It also appears the level of confidence the MMS has in the proposed rule is less than strong, indicating further analysis and clarification of the proposed process is warranted before a rule is issued. Furthermore, the issuance of an Interim Final Rule conflicts with the MMS' stated objective of "adding more certainty to the valuation of oil produced from Federal Lands."

   If the rule is initially issued on an interim basis, lessees will incur all the costs of changing systems and work processes to comply with the Interim Rule, and then be subject to similar costs and disruptions again in order to comply with any substantive changes issued in the Final Rule, all within a relatively short period of time. Based on our analysis of the proposed rule, numerous clarifications regarding critical aspects of the rule need to be addressed and resolved prior to any rulemaking. COPAS believes it is premature to issue either an Interim or Final rule at this time.

3. MMS requested comments on the use of market indicators to determine royalty value, use of NYMEX as an index value, and selection of the proper prompt month.

   COPAS believes that our specific comments on the proposed rule respond to most of the MMS requested comments.

4. MMS requested comments on the initial list of market centers and aggregation points.

   COPAS believes that this question should be responded to by crude oil marketers, but, we did note that the initial list did not include any aggregations points in Wyoming or Utah and that no refineries were listed.

Form MMS-4415

COPAS objects to the proposed data collection requirement as it will impose a significant day-to-day cost of compliance without providing statistically accurate or verifiable results. The proposed rule imposes a new and onerous reporting obligation on federal lessees and/or payors. The Oil Location Differential Report, Form MMS-4415, must be filed by all Federal lessees for all crude oil production sold, regardless of whether from Federal, Indian, State, or private lands. See 62 FR 3755 (Proposed Section 206.105(d)). What authority does MMS have to require reporting of any kind on non-federal leases? The current reporting obligations also remain in place. Form 4415 is an additional burden.

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The rule proposes that this form would:

> *capture location differentials in all exchange agreements or other oil disposal contracts. MMS would use these data to calculate location differentials between market centers and aggregation points. 62FR3749*

COPAS believes the proposed reporting requirement has numerous problems. These problems include, but are not limited to, the ambiguities of the form, the immense burden associated with collecting and using the data requested, and the lack of viability of the data once collected. The purpose of this section is to address these shortcomings.

AMBIGUITIES OF FORM REQUIREMENTS

Form MMS-4415 generates a myriad of questions. Who should complete the form? Precisely what data is being requested? How will the data be used? What controls are in place to insure integrity in the way the data is used? Why is this data needed? These questions are outlined in more detail as follows:

Payor Information - COPAS believes that there is confusion over who should submit Form MMS-4415. The requirements of the proposed regulation state that:

> *You must submit information on Form MMS-4415 related to all your and your affiliates' crude oil production, and not just information related to Federal lease production. All Federal lessees (or their affiliates, as appropriate) must initially submit Form MMS-4415 no later than 2 months after the effective date of this reporting requirement, and then by October 31 of the year this regulation takes effect and by October 31 of each succeeding year.*

However, the form guidelines in Exhibit A of the proposed rule provide that the payor complete the form. Who should complete the form when the payor is not the lessee?

Also, if only the lessee is required to report, it may have insufficient data to complete the report. Similarly, the payor may have insufficient information to complete all the requirements of the form. If a payor and lessee are different and the payor reports on a lessee's transaction, should the payor number of the payor or the lessee be used for reporting purposes? MMS needs to clarify who should report.

Due Dates for Information - In the proposed rule, the MMS requested comments on Form MMS-4415 about "Frequency and timing of submittal, frequency and timing of MMS's calculations..." COPAS believes the data being collected is dated information that cannot predictably reflect a current market. An example of the timing problem is:

DATE	EVENT	ISSUES
5/31/97	Rule Becomes Effective	
7/31/97	Report Deadline for Form MMS-4415	Beginning period for reporting is not addressed; assume last 12 months
10/31/97	Annual Report Deadline	Report not due until 10/31/98 since effective date of rule within six months
10/31/98	Annual Report Deadline	Form MMS-4415 due
12/98	Valuation of Monthly Payment	May be based on data from 19-31 months old
1/1/99	Location Quality Differentials Published	LQD's based on 1998 data
12/1/99	Valuation of Monthly Payment	May be from data 12-24 months old

This timetable illustrates the extremely short time period for initial reporting, the unknown time period for such reporting, and how aged the data being used could become. Early submittal is suggested as an option (62FR3749) in order to allow the MMS to "publish representative market center-aggregation point location differentials in the Federal Register by the effective date of the rule." Given the issues outlined in this section, it is doubtful that there will be sufficient time to report by the first deadline, much less earlier.

Contract Party Name - This item would require the contract party name and MMS Payor Code (if available). Even though the instructions accompanying the exhibit form acknowledge that the payor code may not be known by requiring it only if it is known, obtaining such information would be burdensome.

Contract Type and I.D. - The guidelines accompanying the form in Exhibit A (62FR3758) state "Also, fill in the Contract Number that would allow a third party to clearly identify the document." What number is this? The number assigned to a contract is usually the internal company number. Would that be sufficient to "allow a third party to clearly identify?" Use of both parties' contract numbers would be an additional burden since the other party's contract number is usually not readily available. The fifteen minutes MMS estimates would be needed to complete this form could easily be spent just trying to obtain the right contract number from another company.

Contract Term - Filling in the contract date and its initial term is not usually difficult. However, since an end date is not always available on month to month contracts, how will the MMS know when the contract expires? Will it try to apply the contract for valuation purposes for

too short or too long a time period? How will MMS know when a new contract is entered into for the same mineral lease and that this contract is in effect terminated?

Also, when is a new report required? One lease may be included in a contract one month and not the next. Will a report be required each time any facet of a contract changes? Requiring this would certainly provide the most accurate data; however, it dramatically increases the reporting burden for the lessee and the time required for the MMS to compile the data.

Title Transfer Location - The instructions for identifying the title transfer location appear to require transportation costs in segments if production travels through more than one aggregation point. These costs are not accounted for in this manner and to do so would require a significant effort on a recurring basis. Because MMS will not allow FERC tariffs to be used by a company or company affiliate transporting the company's product, new reports and systems to calculate actual costs will have to be developed.

In addition, this item asks for the MMS lease number or lease numbers. There could be different transportation arrangements when different leases are included. Various leases may even be included in the arrangement from month to month for the same contract. This further complicates not only the reporting by the payor/lessee but also the data compilation by the MMS.

Volume Terms - In the instructions for completing Form MMS-4415, the reporter is advised to "not include production subject to call rights where another party has the right to purchase oil at some redefined price basis or to match other purchaser offers." 62 FR 3758. In reality, if the crude oil call has not been exercised, existence of a call provision may not be known to a reporting entity. Determining that a call exists would require an expensive title review of both public records and private records. If the MMS means that barrels should be excluded where the call has been exercised, then it should be more specific in its instructions.

Crude Quality - Form MMS-4415 also requires sulfur content data for each transaction. The specific sulfur content is not usually kept at the sales transaction level. While the producer may know the sulfur content of each lease, the production can be commingled or aggregated with various other types to provide a specific type of crude under a contract. To determine the sulfur content at the title transfer point or "Market Center" will most likely require an additional sulfur measurement (at an additional cost).

BURDEN ON PAYOR AND MMS

The MMS has estimated the reporting cost imposed by the rule to be $800,000 per year to industry. 62 FR 3750. This estimate is based on the assumption that, on average, a payor would have 64 agreements from which data would need to be extracted. The MMS estimated that it would take 15 minutes to gather the information needed to complete Form MMS-4415.

The MMS further assumed the labor costs to comply with the collection obligation to be $25.00 per hour.

COPAS believes that the MMS estimate is unrealistically low. Because the requirement is not limited to Federal oil, a Federal lessee must complete Form MMS-4415 on every exchange or buy-sell agreement for all crude oil production whether Federal, Indian, State or private. Many payors would be required to collect such data on far more than 64 agreements. This is also disproportionate to the amount of Federal interest a lessee may have leased. For example, a lessee with one Federal lease could be required to report hundreds of other transactions.

COPAS believes that the 15-minute estimate is also low. The time necessary to complete Form MMS-4415 will greatly exceed the fifteen minutes estimated by the MMS. The information is not easily obtained. A list of some of the activities that will add to the costs are:

- research information not in the contracts, e.g. sulfur content, MMS lease numbers, etc.
- break out transportation costs where "oil traverses more than one aggregation point"
- identify all segments of the transportation route
- conduct title research to determine call on production
- collect information from various functions within a company (Marketing, Revenue, - Regulatory, Production) and from an Affiliate when applicable
- obtain information from lessees, payors, other parties to the contract
- complete form for multiple lease transactions
- complete forms for all changes in transactions

Additionally, there will be significant start-up costs for the initial data collection and systems development or modifications to collect data that is either not centrally located or currently not maintained in a database.

The preamble states "All Federal and Indian lessees (or their affiliates as appropriate) would initially submit Form MMS-4415..." 62 FR 3749. It appears that a reporting requirement to provide data via Form MMS-4415 could be created for a company with only Indian royalties, which are not subject to this valuation method.

COPAS does not believe the MMS has sufficiently explained or supported its need for data on transactions not occurring between market centers and aggregation points. A Federal lessee should not be burdened with reporting all transactions, whether Federal, State, or private, regardless of where the transaction occurs (lease, aggregation point, etc.), especially since the usefulness of the data is in question.

Furthermore, in addition to requiring industry to expend time and money reporting each transaction, the MMS will also have to develop a labor intensive and costly system to review and analyze the data.

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VALIDITY OF STATISTICAL DATA

Statistics, or the collection, organization, and interpretation of numerical data, relies on a stable population of information and enough sample data to provide a true reflection of the whole. The information being collected on Form MMS-4415 appears to provide a "mixed bag" of information that will be so diverse and sometimes duplicative that the accuracy of the subsequent location/quality differentials will be in question. The proposed rule provides for the privacy of the information, thus, the concern about accuracy is magnified as there will be no way for industry to verify MMS' calculations.

The MMS has not explained how it will calculate the location/quality differentials. The MMS will have to address how to calculate a weighted-average differential in various situations. This may enhance the statistical accuracy of MMS' computations, but will not shorten the age of the data.

There are several other flaws with the proposed data collection methodology in the proposed rule that would cause duplicate reporting and misrepresentative data. Duplicate reporting can occur, through no fault of the reporting party, when both parties are federal payors and are both reporting the transaction, each from their respective points as payors. The many difficulties with Form MMS-4415 could cause the MMS to overlook the duplication. These include but are not limited to the fact that the transaction may be tied to a federal lease for one payor and to a private lease for another. There could also be differences in terminology regarding the identification of aggregation points.

Duplicate data must be eliminated to calculate statistically accurate location/quality differentials. All transactions will not be required to be reported from both sides. For example, a transaction may be between a federal lessee and a non-federal lessee; therefore, only the federal lessee would be required to report. Another example would be a transaction between two federal parties where one has production subject to a call and the other does not. If the amount of the exchange is 10,000 barrels and the call on one party's barrels is 20%, one party would report 8,000 and the other 10,000. How will this be reconciled by MMS? Which party's barrels would be eliminated?

The preamble to the proposed rule states that "Reporting duplicate information would not be required (e.g. identical location /quality differential between the same point)." 62 FR 3749. This could cause misrepresentative data to be used because a lessee could have three separate high volume sales with identical location/quality differentials between the same point and would be required to only report one sale. The only other sale at the same point could for very low volumes at a radically different price. If the volumes are not taken into account, the location/quality differential calculated by the MMS could statistically misrepresent the differential by making it too low or too high.

As previously discussed. the reliability of MMS' published location/quality differential is a key concern. COPAS believes much of the data collected will not be useful for the calculation of the location/quality differential between MMS-identified aggregation points and market centers. 62 FR 3754 (proposed Section 206.105(c)(i)(iii)). Only reported transactions between aggregation points and market centers will provide MMS data needed for the MMS-published location/quality differential. Transactions occurring between a lease and an aggregation point and sales at index pricing points will be of no relevance to the MMS-calculated differential. Lessees will be required to expend significant resources completing reports on such transactions that will be irrelevant to the MMS' stated purpose -- publication of differentials for each aggregation point and associated market center. 62FR3747.

Conclusion

The proposed rule ignores the lease market which is more appropriate for determining royalty value. Also, the rule, as proposed, would require industry to expend thousands of hours complying with the rule and preparing Form MMS-4415, and would require the expenditure of millions of dollars to modify systems to capture the data needed for reporting. COPAS does not believe the current oil valuation regulations are broken, and urges MMS to withdraw the proposed rule.

Sincerely,

John E. Clark
Chairman, COPAS Federal Affairs Subcommittee

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cc:
Larry Monzingo
Bill Stone
Mary Stonecipher
COPAS Federal Affairs Subcommittee

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